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February 14, 2006

AGENDA ITEM 6f

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Revision of Agenda Item 6f
Permissible Equity Market Analysis Update

II. PROGRAM: Global Equity

III. RECOMMENDATION: Information Only

IV. ANALYSIS

Attachment 1 is an updated draft permissible equity market policy analysis prepared by Wilshire Associates. The final policy will be presented at the April Investment Committee meeting, allowing each country time to review and comment on the analysis. Roz Hewsenian will present the analysis and will be available to answer any questions the Investment Committee may have.

History of the Permissible Equity Analysis

Over the seventeen years CalPERS has been investing in international equity markets, Wilshire Associates has prepared and presented for Investment Committee approval lists of countries in which investments were to be permitted and lists of countries in which investments were to be either restricted or prohibited.

On November 13, 2000, the Investment Committee approved significant changes to this country investibility screening process including:

1. Enhancing the screens to include Financial Transparency, Political Stability, and Prohibitions on Abusive Labor Practices, including incorporating the International Labor Organization (ILO) Declaration of Fundamental Principles and Rights to Work.

2. Deciding to hire active emerging market managers to screen at the company level for the same factors, with the addition of the Global Sullivan Principles, and to report annually to the Investment Committee.

At its February 19, 2002 meeting, the Investment Committee approved a new Permissible Equity Market list and directed Wilshire to update the analysis annually. The current list was approved at the April 18, 2005 Committee meeting.

On November 15, 2004, the Committee approved a CalPERS Permissible Equity Policy for Emerging Equity Markets, detailing the standards and parameters for the permissible market screening, including the Investment Committee's approval process. Specifically, the general pension consultant shall present a draft Permissible Equity Market list at the February Investment Committee meeting as an informational item. An interim posting at the March Investment Committee meeting shall be provided, and formal adoption of the final recommendation shall occur at the April Investment Committee meeting of each calendar year. This process allows countries a 30-day review and comment period prior to the final list approval.

For the year ending December 31, 2005, CalPERS' emerging market portfolio returned 34.43%, net of fees. Since its inception on August 1, 2002, the emerging markets portfolio has returned 35.41%, net of fees, annualized.

Economic Impact of Permissible Equity Market Restrictions

Table 1 below shows the return results of the CalPERS Custom Emerging Market index, which is constrained by the Permissible Equity Market list, as compared with the standard FTSE All Emerging Index. The data is shown from inception on April 1, 2002 through December 31, 2005. Note that Wilshire reports calendar year results in their executive summary rather than one and two year annualized returns, so some of the numbers in the Wilshire executive summary differ from those shown below due to the different time periods used. However, from inception results shown in the Wilshire executive summary are identical to those reported by staff below.

Table 1 - CalPERS Benchmark Return versus Unconstrained Benchmark Return

	One-Year Return	Annualized Two-Year Return	Annualized Return Since April 2002
CalPERS Custom Emerging Market Index	33.6%	32.8%	21.6%
FTSE All Emerging Index	35.1%	31.5%	23.8%
Difference	(1.5)%	1.3%	(2.2)%

The return differential can also be viewed by comparing the actual portfolio returns achieved for CalPERS by its three emerging markets managers to the composite returns achieved for other clients who use a standard benchmark. Two of CalPERS' three emerging markets managers achieved higher returns for clients who do not have CalPERS' country restrictions. This data is shown in Table 2 through December 31, 2005.

Table 2 - CalPERS Return versus Manager's Unconstrained Composite Return

	CalPERS Annualized Gross Return Since July 31, 2002	Unconstrained Portfolio Annualized Returns Since July 31, 2002	Difference
AllianceBernstein	39.8%	42.2%	(2.4)%
Dimensional Fund Advisors	35.4%	33.4%	2.0%
Genesis Asset Managers	32.4%	39.1%	(6.7)%
Asset Weighted Annualized Return Difference			(2.1)%

The (2.1%) cumulative difference in returns from inception equates to an opportunity loss of approximately ~~$641.5~~ $203 million based on the ~~weighted average~~ assets managed during this period. As of December 31, 2005, CalPERS had $4.7 billion invested in emerging markets only portfolios.

In addition to returns, staff measures the volatility, defined as the standard deviation of monthly returns, of the returns from the custom benchmark for CalPERS' emerging markets managers and compares it to the volatility of the standard benchmark. Since April 2002, the standard deviation of the CalPERS Custom Emerging Market Index was 19.8%, versus 18.5% for the unconstrained FTSE All Emerging Index. This means the return pattern of CalPERS' custom benchmark is more volatile, or riskier. This result is expected as the custom benchmark is less diversified due to the elimination of certain countries' equity markets. The elimination of these markets also means the custom benchmark can have very different sector weights than the standard benchmark because many emerging markets do not have economies that are as well diversified as the economies of many developed markets.

V. STRATEGIC PLAN:

This item is consistent with the Strategic Plan: Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits, and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

Changes to CalPERS' permissible equity market list will result in transaction costs. Staff will work to mitigate those costs by taking advantage of available crossing opportunities and transitioning the assets over a reasonable period of time.

There is an annual cost of $921,749 per year for subcontractors to research factors in the permissible equity market analysis. Expenditures since the Investment Committee approved the subcontractors' research at its May 14, 2001 meeting through December 31, 2005 are $4.6 million.

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